WALLY HERGER
2D DISTRICT, CALIFORNIA

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Congress of the United States
House of Representatives
Washington, DC 20515–0502

December 13, 2005

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Delivered Via Fax to (202) 622-4733, Attn. Mr. Floyd Williams

Dear Commissioner Everson:

Several time-sensitive questions have been brought to my attention concerning the tax treatment of roughly 2,700 of my northern California constituents, all of whom recently received cash awards from the State of California in an inverse condemnation decision by the courts. I would appreciate your review of this matter, and a response at your earliest convenience.

On February 20, 1986, the Linda levee on the Yuba River broke, resulting in millions of dollars of flood-related damages to several communities in Yuba County. After years of court challenges, an appellate court reversed an earlier lower court's judgment in favor of the State of California, and ruled in favor of the plaintiffs in Paterno v. State of California (Paterno). The court held that the plaintiffs' damages were directly caused by an unreasonable State plan, which resulted in the failure of the Linda levee. In the end, the State agreed to pay damages plus interest and attorney fees, amounting to $428 million.

I have included several questions that have arisen concerning how these awards will affect the tax liability of flood victims, all of which originated from tax preparers who are helping to advise many local award recipients. It is of the utmost importance that these questions receive immediate attention so that my constituents involved in this matter will receive accurate tax advice presently, and will not later face unnecessary scrutiny due to the sheer complexity of this situation and a lack of information.

1. Capitalization of attorney fees and costs, treatment of prejudgment interest, and gain or loss on inverse condemnation per Leonard v. Commissioner, 94 F. 3d 523 (9th Cir. 1996)

As explained by Mr. David Shaw, an Enrolled Agent and constituent of mine from Yuba City, and in greater detail in a memorandum from Ms. Margaret A. Martin, General Attorney with IRS Sacramento, Group 2 (Small Business/Self-Employed), the Leonard case and the Paterno case both deal with inverse condemnations. In addition, the settlement of both cases included prejudgment interest even though the Paterno case did not directly call the additional income "prejudgment interest." In Leonard, the court indicated that "interest on a condemnation award is not part of the award; instead, it represents compensation for the delay in payment, and is taxable as ordinary income." In the attached memo from Ms. Martin, she cites four other cases that reach the same conclusion regarding the treatment of "prejudgment interest." Therefore, my constituents have asked, even though the Paterno case did not classify the increased income due to delay in payment of "prejudgment interest," will the Internal Revenue Service agree that this income is prejudgment interest and should be treated in accordance with the precedence set forth in the Leonard case and IRC Sec. 61?

At the individual taxpayer level, I am concerned that many of my constituents will be captured by the alternative minimum tax on the settlement largely from having Paterno-related attorney fees deducted on Schedule A subject to the 2% limitation. However, as in the Leonard case and IRC Sec. 212, attorney fees in relation to an inverse condemnation should be capitalized unless the fee agreement specifically addressed prejudgment interest. In short, since the Paterno fee agreement did not address "prejudgment interest," would the IRS agree that 100 percent of the attorney fees should be capitalized, and therefore not included on Schedule A?

Mr. Shaw would like to know if the attorney fees should be capitalized and, in accordance with IRC Sec. 1016, 1001, and 1011, the new adjusted basis calculated in order to determine a taxpayer's gain or loss on the inverse condemnation, the type of property involved in the Paterno case would decide the treatment of the gain or loss. In short, some gains and losses may be excluded under IRC Sec. 121, while others may be fully taxable or deductible depending on the type of property involved in the inverse condemnation. If this is a position that the IRS would agree correctly cites the Leonard case and the above mentioned IRC sections, or would the taxpayer be entitled to an additional casualty loss in any case due to the excess basis remaining?

2. Insufficient information provided to flood victims regarding IRS Form 1099

The second issue was brought to my attention by Mr. Doug Gray, a tax preparer and constituent of mine from Yuba City. As it was explained to me, flood victims received a check from their attorneys, and in some cases a note, indicating how much of their award was allocated to attorney fees and expenses. In addition, they received an IRS Form 1099 Miscellaneous.

Both Mr. Gray and Mr. Shaw have inquired about how the IRS will process the returns from the Yuba flood victims. Specifically, they would like to know if, because of the 1099 Miscellaneous and the possible need to split up individuals' awards into prejudgment interest and

attorney fees, the IRS's computers will erroneously identify the flood victims as not having reported taxes correctly? How will the CP2000 system process these returns? Is there a way the IRS can protect these taxpayers from unnecessary scrutiny of this kind, perhaps through a special designation that will identify returns with the Yuba flood? Do the taxpayers need additional information to properly calculate tax liability?

If these questions can be readily answered, I believe it would greatly benefit the tax preparers in Yuba County to have a representative from Washington on hand at a small forum to discuss this issue and answer any other questions that may come up.

This is an issue that affects a large number of my constituents, all of whom are taxpayers facing an uncertain tax burden. Prior to taxes coming due, I believe every effort should be made to inform these individuals about their tax situation, and ramifications for non-compliance. I am aware that the tax preparers in Yuba County have made several outreach efforts. I would appreciate learning of the IRS efforts to inform taxpayers of their potential tax liability in this scenario.

Again, thank you in advance for your timely and thorough review of this pressing issue. I would very much appreciate your continued attention to this matter, as it adversely impacts so many of my northern California constituents, and will follow up with you and your staff.

Sincerely,

WALLY HERGER
Member of Congress

encl.

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:SB:7:SAC:2:MAMartin
TRNEX-138491-05

date: OCT 13 2005

To: Area Director, SPEC
Attn: Bob Meyer, Territory Manager (Sacramento)

from: Area Counsel (SBSE), Area 7
Sacramento Office

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subject: Tax Consequences of Payments Received for Flood Damage

This is in response to your inquiry concerning the tax treatment of attorneys' fees included in a settlement entered into between the State of California (hereinafter "the State") and numerous Yuba County residents. The settlement was of litigation relating to flood damage resulting from the collapse, on February 20, 1986, of the Linda levee at the confluence of the Yuba and Feather Rivers in northern California.

Approximately 3,000 plaintiffs[1] sued the State and others, seeking damages for inverse condemnation liability.[2] Initially, the lower court found against the plaintiffs, but the appellate court reversed and ordered a new trial. Sample plaintiffs subsequently lost in the lower court and the case was again appealed. This time the appellate court reversed the lower court's judgment in favor of the State and held in favor of the sample plaintiffs, on the grounds that their damages were directly caused by an unreasonable State plan which resulted in the failure of the Linda levee and that the State was liable to pay for the damages. Paterno v. State of California, 113

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[1] To our knowledge, the litigation was not a class action.

[2] Inverse condemnation liability stems from the California Constitution and is not dependent on tort or private property principles of fault. Cal. Const., art. I, § 19. See Albers v. County of Los Angeles 62 Cal.2d 250, 261-262, 42 Cal.Rptr. 89, 398 P.2d 129 (1965). The theory is that the private individual should not be required to bear a disproportionate share of the costs of a public improvement, which would be the result if there was damage to the individual, and liability on the part of the public entity, and the individual was not reimbursed for the damage by the public entity. See, Locklin v. City of Lafayette, 7 Cal. 4th 327, 367-368, 27 Cal.Rptr.2d 613, 867 P.2d 724 (1994).

Cal.App.4th 998, 6 Cal.Rptr.3d 854 (1999). The appellate court remanded for further proceedings necessary to determine the damages of nonsample plaintiffs (the sample plaintiffs' damages had been stipulated), and it awarded the sample plaintiffs costs of suit, including "reasonable attorney, appraisal, and engineering fees" actually incurred, pursuant to section 1036 of the California Code of Civil Procedure.

Subsequently, the majority of the plaintiffs entered into a settlement agreement with the State of California, pursuant to which the State paid $428,000,000 into an escrow account. You have informed us that approximately $100,000,000 of the $428,000,000 was for damages, $171,200,000 was for attorneys' fees as agreed in the settlement, and $156,800,000 was prejudgment interest. During July 2005, plaintiffs received their proportionate shares of the $428,000,000, less the attorneys' fees.

LEGAL ANALYSIS

Section 61 of the Internal Revenue Code provides that, except as otherwise provided by the Code, gross income includes all income from whatever source derived. Any funds or other accessions to wealth received by a taxpayer are presumed to be gross income and are includable as such in the taxpayer's return, unless the taxpayer can demonstrate that the funds or accessions fit into one of the specific exclusions created by the Code. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429-431 (1955); Getty v. Commissioner, 913 F.2d 1486, 1490 (9th Cir. 1990).

To determine whether an award of damages or a settlement payment constitutes gross income, it is necessary to look to the nature of the underlying action. Getty, 913 F.2d at 1490. Settlement proceeds constituting a return of capital or damages for the impairment of capital are taxable only to the extent that they exceed the basis of the property replaced. OKC Corp. & Subs. v. Commissioner, 82 T.C. 638, 650 (1984). Thus, condemnation awards (excluding interest) are amounts realized for purposes of computing gain or loss on property, and may be taxable as ordinary income or as capital gains, depending upon how the property was held. Casalina Corp. v. Commissioner, 60 T.C. 694 (1973).

Interest on a condemnation award is not part of the award; instead, it represents compensation for the delay in payment, and is taxable as ordinary income. Kieselbach v. Commissioner, 317 U.S. 399 (1943); Leonard v. Commissioner, 94 F.3d 523 (9th

Cir. 1996); Tiefenbrunn v. Commissioner, 74 T.C. 1566, 1572 (1980); Casalina Corp.; Wilson v. Commissioner, T.C. Memo. 1996-418.

The U.S. Supreme Court recently held that, as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee, as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery. Banks v. Commissioner, 543 U.S. ___, 125 S. Ct. 826, 160 L.Ed. 2d 859 (2005).[3]

The deductibility of attorneys' fees is determined by looking to the origin of the claim. United States v. Gilmore, 372 U.S. 39, 47-48 (1963). Attorneys' fees paid to establish the sales price of property are capital expenditures and therefore not deductible. United States v. Hilton Hotels Corp., 397 U.S. 580, 584 (1970). Attorneys' fees paid to obtain interest, which is ordinary income, are deductible. Kovacs v. Commissioner, 100 T.C. 124, 133 (1993), aff'd by unpublished disposition, 25 F.3d 1048 (6th Cir.) cert. denied, 513 U.S. 963 (1994).

Where a taxpayer had entered into a contingency fee agreement with the attorney, the taxpayer is entitled to deduct that amount the taxpayer actually paid the attorney according to the contingency fee agreement to obtain the taxpayer's share of the pre-judgment interest portion of the award. Leonard, 94 F.3d at 526.[4] The Court in Leonard rejected arguments that the deductible amount should be based either on a ratio of billed hours related to interest to total billed hours, or on a ratio of amount recovered for prejudgment interest to total amount recovered.

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[3] The Supreme Court in Banks explicitly declined to reach the issue of whether sums awarded to an attorney under a fee shifting statute are includable in the client's gross income. A fee shifting statute is a statute providing for a party to pay the other party's fees. Section 1036 of the California Code of Civil Procedure is such a fee shifting statute, in that it requires, in part, that in any inverse condemnation proceeding the attorney representing the public entity who effects a settlement of the proceeding shall allow as part of the settlement a sum that will reimburse the plaintiff's reasonable costs, disbursements, and expenses, including reasonable attorneys' fees. The Ninth Circuit has held that a defendant's payment of a plaintiff's attorneys' fees and costs pursuant to a fee shifting statute constitutes income to the taxpayer. Sinyard v. Commissioner, 268 F.3d 756 (9th Cir. 2001); Vincent v. Commissioner, T.C. Memo. 2005-85.

[4] Leonard involved a California inverse condemnation.

Note -

For purposes of this opinion, the Attorney Assumed that the Taxpayer can correctly allocate $5,000 of interest to determining pre-judgement interest award.

The Leonard case holds that to properly allocate Atty fees to pre judgement interest, there must be a specific hearing or action that results in the computation of pre judgement interest.

The Taxpayer may claim that there is no seperate action to which a portion of the Atty fee may be allocated. In this case, all Atty fees would relate to determing the amount of the award.

Atty fees related to the compensation for loss are capitalized and used to determine gain or loss from the event giving rise to the award.

As an example of the above discussion, assume that an individual taxpayer received a payment of $85,599 as a result of the litigation, calculated as follows[5]:

Proportionate share of total award, including interest and attorneys' fees paid by State	$142,666
Amount of attorney's fees retained	$57,067
Amount of cash received by taxpayer	$ 85,599

Further assume that the $142,666 includes $52,267 of prejudgment interest, that the attorneys' fees were based upon a contingency fee agreement, that the $57,067 of attorneys' fees included $5,000 actually expended on the matter of the prejudgment interest,[6] and that all damages received were for damages to a capital asset.

The taxpayer should (1) report the $52,267 of prejudgment interest as ordinary income; (2) treat the remaining $90,399 as the amount realized in computing gain or loss; (3) deduct the $5,000 of attorney's fees attributable to the prejudgment interest (although the $5,000 of attorneys' fees is deductible in this example, the deduction under I.R.C. §212(1) is subject to the 2% floor of I.R.C. §67); and (4) capitalize the remaining $52,067 of attorneys' fees (this is an adjustment to basis pursuant to I.R.C. §1016). The taxpayer's gain or loss on the "sale" of the property (the inverse condemnation) pursuant to I.R.C. §1001 is the amount realized of $90,399 less the adjusted basis (§1011). In this example, the calculation would be $90,399 less the sum of the taxpayer's pre-settlement basis plus $52,067. Finally, the taxpayer might be entitled to exclude the net gain entirely if he or she meets the requirements of §121 (exclusion of gain for sale or exchange of a principal residence, see I.R.C. §121(d)(5)).

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[5] Since there were approximately 3,000 plaintiffs, we are using 1/3,000 of each of the amounts you gave us.

[6] The party asserting that a portion of the attorney's fees was actually paid to obtain the taxpayer's share of the pre-judgment interest portion of the award would need evidence to prove that portion. In Leonard there was an actual hearing relating solely to the prejudgment interest, so it was possible in that case to make such an allocation. Absent any such evidence, no portion of the attorney's fees would be deductible (as opposed to a capital expenditure).

We would be happy to provide additional assistance to you in this matter. If you wish additional assistance, please call Margaret A. Martin at (916) 974-5700.

PATRICIA A. DONAHUE
Area Counsel
(Small Business/Self-Employed)

By: Margaret A. Martin
Margaret A. Martin
General Attorney (Sacramento, Group 2)
(Small Business/Self-Employed)

cc:

Division Counsel
SB TL

Area Counsel
Area 7
SB

4 of 5 DOCUMENTS

JOHN B. LEONARD; BETTY B. LEONARD, Petitioners-Appellants, v. COMMISSIONER INTERNAL REVENUE SERVICE, Respondent-Appellee. JAMES v. CREWS; DOROTHEA G. CREWS, Petitioners-Appellants, v. COMMISSIONER INTERNAL REVENUE SERVICE, Respondent-Appellee.

No. 95-70046, No. 95-70047

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

94 F.3d 523; 1996 U.S. App. LEXIS 23234

May 7, 1996, * Submitted, Pasadena, California

* The panel unanimously finds this case suitable for disposition without oral argument. Fed. R. App. P. 34(a); 9th Cir. R. 34-4.

July 31, 1996, Filed

SUBSEQUENT HISTORY: [**1] As Amended September 5, 1996.

PRIOR HISTORY: Appeals from a Decision of the United States Tax Court. Tax Ct. No. 19696-91, Tax Ct. No. 14450-91. Arthur L. Nims III, Tax Court Judge, Presiding.

Original Opinion Previously Reported at: *1996 U.S. App. LEXIS 18789.*

DISPOSITION: AFFIRMED in part, REVERSED in part, and REMANDED.

CASE SUMMARY:

PROCEDURAL POSTURE: Petitioner taxpayers challenged a decision by the United States Tax Court, which upheld in part respondent Commissioner of Internal Revenue's determination of tax deficiencies for petitioners' failure to report the prejudgment interest portion of an inverse condemnation award as ordinary income. Two petitioners challenged the tax court's upholding of penalties assessed for substantial understatement and negligent underpayment of income tax.

OVERVIEW: Petitioner taxpayers challenged the tax court's decision, which upheld in part respondent Commissioner of Internal Revenue's determination that petitioners were liable for tax deficiencies due to their failure to report the prejudgment interest portion of an inverse condemnation award as ordinary income. The court affirmed because the prejudgment interest portion of an eminent domain award was ordinary income and there was no relevant distinction between an eminent domain action and the inverse condemnation action. The court reversed the determination that petitioners could deduct only three percent of the total amount of attorney fees and remanded for recalculation of their tax deficiencies because petitioners were entitled to deduct what they actually paid their lawyers to obtain their share of the prejudgment interest portion of the award. The court affirmed the imposition of penalties against two petitioners for negligent underpayment and substantial understatement of their taxes because a reasonable taxpayer would not have relied simply on the word of neighbors or failed to inform the tax preparer that assisted them in the preparation of their tax return.

OUTCOME: The court affirmed the finding that petitioner taxpayers' prejudgment interest award in an inverse condemnation action was ordinary income and the assessment of penalties on two petitioners, who did not act reasonably, for substantial understatement and negligent underpayment of tax. The court reversed the determination of deductible attorney fees because petitioners were entitled to deduct the total amount paid to recover the award.

LexisNexis(R) Headnotes

Tax Law > Federal Tax Administration & Procedure > Tax Court (IRC secs. 7441-7491)
Civil Procedure > Appeals > Standards of Review > De Novo Review
[HN1] The court reviews de novo the tax court's determination that the prejudgment interest portion of the taxpayers' award is ordinary income.

Tax Law > Federal Income Tax Computation > Unearned Income > Interest Income (IRC sec. 61)
Tax Law > Federal Taxpayer Groups > Individuals > Gross Income (IRC sec. 61)
[HN2] *I.R.C. § 61(a)(4)* provides that gross income means all income from whatever source derived, including interest. *26 U.S.C.S. § 61*(a)(4).

Tax Law > Federal Income Tax Computation > Unearned Income > Interest Income (IRC sec. 61)
[HN3] Department of the Treasury regulations provide that interest income includes the interest portion of a condemnation award. *26 C.F.R. § 1.61-7(a).*

Tax Law > Federal Income Tax Computation > Unearned Income > Interest Income (IRC sec. 61)
[HN4] The prejudgment interest portion of an eminent domain award is ordinary income.

Tax Law > Federal Income Tax Computation > Unearned Income > Interest Income (IRC sec. 61)
Real & Personal Property Law > Eminent Domain Proceedings
[HN5] There is no relevant distinction between an eminent domain action and an inverse condemnation action. Eminent domain and inverse condemnation are two sides of the same coin. In both types of actions, a property owner seeks compensation for the value of his property taken by the government. When payment is delayed pending litigation, the property owner is generally entitled to an additional award to make up for the interest he could have earned if he had been compensated earlier and had put the money to work. The taxpayers' prejudgment interest award is ordinary income.

Tax Law > Federal Income Tax Computation > Deductions for Business Expenses > Capital Expenditures (IRC secs. 263-263A)
Tax Law > Federal Taxpayer Groups > Individuals > Production of Income Expenses (IRC sec. 212)
[HN6] Taxpayers are not entitled to deduct the entirety of their attorney fees incurred and paid to obtain an award. Although taxpayers generally can deduct expenses to produce income, *26 U.S.C.S. § 212*, they cannot deduct "capital expenditures." *26 U.S.C.S. § 263.*

Tax Law > Federal Income Tax Computation > Deductions for Business Expenses > Capital Expenditures (IRC secs. 263-263A)
Tax Law > Federal Taxpayer Groups > Individuals > Production of Income Expenses (IRC sec. 212)
[HN7] The court determines when to treat attorney fees as deductible by looking at the origin of the claim. Attorney fees paid to establish the sales price of property are capital expenditures and therefore not deductible. Attorney fees paid to obtain interest, which is ordinary income, are deductible.

Tax Law > Federal Income Tax Computation > Unearned Income > Interest Income (IRC sec. 61)
Tax Law > Federal Taxpayer Groups > Individuals > Production of Income Expenses (IRC sec. 212)
[HN8] Taxpayers are entitled to deduct what they actually paid their lawyers, according to a contingent fee contract, to obtain their share of a prejudgment interest portion of an inverse condemnation award.

Tax Law > Federal Tax Administration & Procedure > Tax Liabilities & Credits > Civil Penalties (IRC secs. 6651-6751)
[HN9] A taxpayer is negligent in underpaying taxes when he fails to do what a reasonable and ordinary prudent taxpayer would do under the circumstances.

COUNSEL: Peter B. Brekhus, Brekhus, Williams, Webster & Hall, Greenbrae, California, for the petitioners-appellants.

Gary R. Allen, United States Department of Justice, Tax Division, Washington, D.C., for the respondents-appellees.

JUDGES: Before: Floyd R. Gibson, ** John T. Noonan, Jr. and David R. Thompson, Circuit Judges. Opinion by Judge Thompson.

** Honorable Floyd R. Gibson, Senior Circuit Judge for the Eighth Circuit, sitting by designation.

OPINIONBY: DAVID R. THOMPSON

OPINION: [*524] ORDER AND AMENDED OPINION

THOMPSON, Circuit Judge:

John B. Leonard, III, Betty B. Leonard, James V. Crews and Dorothea G. Crews (taxpayers) appeal a decision by the United States Tax Court upholding in part the Commissioner of Internal Revenue's (Commissioner)

determination of tax deficiencies for the taxpayers' failure to report as ordinary income the prejudgment interest portion of an inverse condemnation [**2] award. The taxpayers also challenge the tax court's method of calculating the amount of attorney fees which is deductible from the prejudgment interest portion of the award. In addition, the Crewses appeal the tax court's upholding of additional penalties assessed against them by the Commissioner for substantial understatement and negligent underpayment of their income tax.

We have jurisdiction pursuant to *26 U.S.C. § 7482*(a). We affirm the tax court's determination that the taxpayers' prejudgment interest award is ordinary income and that the Crewses are liable for additional penalties for substantial understatement and negligent underpayment of tax on that income. We reverse the tax court's determination of the amount of deductible attorney fees, and we [*525] remand for recalculation of the tax deficiencies of all of the taxpayers and the penalties assessed against the Crewses.

FACTS

In 1980, the taxpayers and others (class plaintiffs) sustained flood damage to their personal residences. The City of San Bernadino declared their homes to be uninhabitable and demolished them. The class plaintiffs filed a lawsuit against the City, the County of San Bernadino, and the San Bernadino Flood [**3] Control District (collectively, San Bernadino) for inverse condemnation. The plaintiffs' contingent fee contract with their attorneys guaranteed the lawyers twenty-five percent of any amount recovered, including any award of prejudgment interest, plus $ 125 per billable hour of time spent on the case.

The class plaintiffs won a jury verdict. Their total recovery was $ 4,101,321, which included court-awarded attorney fees and prejudgment interest. The Leonards' share of the award was $ 299,036, which included $ 156,596 of prejudgment interest. The Crewses' share was $ 216,039, which included $ 105,183 of prejudgment interest.

Pursuant to their agreement with their counsel, the class plaintiffs owed approximately $ 1.6 million in attorney fees. The attorney fees consisted of the attorneys' contingency fee plus hourly fees of $ 125 per hour computed on 4900 hours bills during the case. Of these hours, 142 hours, or three percent of the total hours billed, related solely to obtaining the prejudgment interest award.

The judgment entered in the inverse condemnation action included attorney fees of $ 700,000 to be paid by San Bernardino. This left a shortfall of $ 900,000 to be made up [**4] by the class plaintiffs. They paid their respective shares of the attorney fees in proportion to the percentage of the award each plaintiff received.

The taxpayers then turned their attention to the preparation of their tax returns. The Leonards hired a certified public accountant (CPA), who determined that the prejudgment interest portion of the award was a return of capital and thus was not includable as ordinary income. The Leonards filed their return on this basis, treating the prejudgment interest as a capital gain.

The Crewses did not inform their tax preparer of the award. Relying on information they received from other flood victims, they decided the prejudgment interest was not reportable at all; thus, they filed their tax return without any mention of the award.

The Commissioner issued notices of deficiency. The taxpayers challenged these deficiencies in the tax court. The tax court held that the prejudgment interest portion of the award was ordinary income, and that attorney fees attributable to this portion of the award were deductible as an income-producing expenditure. To determine the amount of the deduction, the tax court decided that because the class plaintiffs' [**5] attorneys had spent three percent of their total billable hours in obtaining the prejudgment interest portion of the award, three percent of the total amount of attorney fees was properly allocable to the recovery of the prejudgment interest portion of the award.

The tax court also held that the Crewses were liable for penalty additions to their tax for substantial understatement and negligent underpayment of income tax.

DISCUSSION

I

[HN1] We review de novo the tax court's determination that the prejudgment interest portion of the taxpayers' award is ordinary income. *Kelley v. Commissioner, 45 F.3d 348, 350 (9th Cir. 1995).*

[HN2] *Section 61(a)(4) of the Internal Revenue Code* provides that gross income means all income from whatever source derived, including interest. *26 U.S.C. § 61*(a)(4). [HN3] Department of the Treasury regulations provide that interest income includes "the interest portion of a condemnation award." *26 C.F.R. § 1.61-7(a).*

The taxpayers argue that the prejudgment interest portion of an inverse condemnation award is not income because it is [*526] paid to meet the constitutional mandate of just compensation under the Fifth Amendment. This argument was considered and rejected by the [**6] Supreme Court in *Kieselbach v. Commissioner, 317 U.S. 399, 87 L. Ed. 358, 63 S. Ct. 303 (1943),* where the Court held that [HN4] the prejudgment interest portion of an eminent domain award is ordinary income.

[HN5] There is no relevant distinction between the eminent domain action in *Kieselbach* and the inverse condemnation action here. Eminent domain and inverse condemnation are two sides of the same coin. In both types of actions, a property owner seeks compensation for the value of his property taken by the government. When payment is delayed pending litigation, the property owner is generally entitled to an additional award to make up for the interest he could have earned if he had been compensated earlier and had put the money to work. The tax court correctly held that the taxpayers' prejudgment interest award was ordinary income.

II

It is undisputed that the [HN6] taxpayers are not entitled to deduct the entirety of their attorney fees incurred and paid to obtain the award. Although taxpayers generally can deduct expenses to produce income, *26 U.S.C. § 212*, they cannot deduct "capital expenditures." *26 U.S.C. § 263*.

[HN7] The court determines when to treat attorney fees as deductible by looking at the origin of the claim. [**7] *United States v. Gilmore, 372 U.S. 39, 47-48, 9 L. Ed. 2d 570, 83 S. Ct. 623 (1963)*. Attorney fees paid to establish the sales price of property are capital expenditures and therefore not deductible. *United States v. Hilton Hotels Corp., 397 U.S. 580, 584, 25 L. Ed. 2d 585, 90 S. Ct. 1307 (1970)*. Attorney fees paid to obtain interest, which is ordinary income, are deductible. *Kovacs v. Commissioner, 100 T.C. 124, 133 (1993), aff'd by unpublished disposition, 25 F.3d 1048* (6th Cir.), *cert. denied, U.S. , 115 S. Ct. 424 (1994)*.

The tax court determined that the taxpayers could deduct only three percent of the total amount of attorney fees, because only three percent of the attorneys' billable hours were expended to obtain the prejudgment interest portion of the award. We reject this approach, because it ignores the contingent fee portion of the taxpayers' contract with their lawyers, and allocates fees only on the basis of the hourly rate portion of the contract.

The taxpayers argue they should be able to deduct that portion of their attorney fees which is equal to the percentage of the recovery attributable to prejudgment interest. Because prejudgment interest accounted for roughly fifty percent of the total award, they [**8] contend they should be entitled to deduct that percentage of the total attorney fees paid.

We also reject the taxpayers' approach, because it would give them a windfall deduction. Using their formula, they would get a deduction of nearly fifty percent of the total fees paid, and yet they did not pay that to obtain the interest portion of the award. According to their contingent fee contract, to obtain the prejudgment interest portion of the award the class plaintiffs paid their lawyers twenty-five percent of the prejudgment interest recovery plus $ 125 per hour for the hours expended to make that recovery.

We conclude the [HN8] taxpayers are entitled to deduct what they actually paid their lawyers, according to the contingent fee contract, to obtain their share of the prejudgment interest portion of the award. Thus, they are entitled to deduct twenty-five percent of their proportionate share of the prejudgment interest portion of the award, plus their proportionate share of $ 17,750 (142 x $ 125).

III

The Commissioner imposed, and the tax court upheld the imposition of, penalties against the Crewses for negligent underpayment of tax pursuant to *26 U.S.C § 6653*(a)(1) (as in effect for [**9] fiscal year 1987), and substantial understatement of tax pursuant to *26 U.S.C. § 6661*(a) (as in effect for fiscal year 1987).

The record shows the Crewses decided not to tell their tax preparer about the interest award and decided not to disclose it on their [*527] tax return. They did so in reliance on the advice of neighbors who also participated in the class action. Mr. Crews testified that the neighbors he spoke with told him that they were not reporting any portion of the award and that some of the neighbors said they had been advised by certified public accountants not to report the award. Mr. Crews also testified he did not tell his tax preparer about the award for fear of confusing him.

We conclude that a reasonable taxpayer deciding how to treat an award of prejudgment interest such as the award in this case would not rely simply on the word of neighbors. *See Sammons v. Commissioner, 838 F.2d 330, 337 (9th Cir. 1988)* [HN9] (taxpayer is negligent in underpaying taxes when he fails to do what a reasonable and ordinary prudent taxpayer would do under the circumstances). The Crewses used a tax preparer to assist them in the preparation of their tax return. Their failure to inform him [**10] of the interest award is difficult to understand. They committed to him the responsibility of preparing their tax return, but instead of seeking his advice on the tax implications of the interest award, they relied on the tax advice of neighbors, none of whom according to the record had any tax expertise. We agree with the tax court that this is not what an ordinary prudent taxpayer would have done under the circumstances.

We conclude the tax court did not err in determining that the Crewses were liable for penalties for negligent underpayment and substantial understatement of their taxes. The penalties, however, will have to be recalcu-

lated in view of the additional deduction of attorney fees to which the Crewses are entitled.

CONCLUSION

We affirm the tax court's decision that the prejudgment interest portion of the inverse condemnation award is reportable as ordinary income by both the Crewses and the Leonards. We vacate, however, the tax court's deficiency determinations for all of these taxpayers and remand their cases to the tax court for recalculation of their tax deficiencies, applying the proper deductions for attorney fees as set forth in this opinion.

We also affirm the [**11] tax court's imposition of penalties against the Crewses for negligent underpayment and substantial understatement of their income tax; however, we vacate the amount of such penalties, and direct the tax court to recalculate the penalties when it recalculates the Crewses' tax deficiency.

Each of the parties shall bear its, his and her own costs on appeal.

AFFIRMED in part, REVERSED in part, and REMANDED.

ORDER

The opinion filed July 31, 1996, is amended as follows:

At Slip Opinion page 9329, the last sentence of the first full paragraph is amended to read: Thus, they are entitled to deduct twenty-five percent of their proportionate share of the prejudgment interest portion of the award, plus their proportionate share of $ 17,750 (142 x $ 125).